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IN THE

SUPREME COURT OF THE UNITED STATES

FEBRUARY TERM, 1975

No. 74-1039

JOSEPH B. ZYCHINSKI and MARIE H. ZYCHINSKI,
Petitioners,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ESTATE OF HENRY J. RICHTER, ERMA A. RICHTER and NANCY MONSON,
Executrices, and ERMA A. RICHTER, Individually,
Petitioners,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI

To the United States Court of Appeals
for the Eighth Circuit

HARVEY G. SCHNEIDER
RASKAS, RUTHMEYER, SCHNEIDER &
POMERANTZ
930 Paul Brown Building
818 Olive Street
St. Louis, Missouri 63101
Attorneys for Petitioners

St. Louis Law Printing Co., Inc., 812 Olive Street 63101 314-231-4177

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The taxpayers-petitioners in these related cases, Joseph B. Zychinski and Marie H. Zychinski and the Estate of Henry Richter, deceased, Erma A. Richter and Nancy Monson, Executrices, and Erma A. Richter, individually, hereby petition for a Writ of Certiorari to review the judgment of the United States Court of Appeals for the Eighth Circuit in these cases.

OPINIONS BELOW

The opinion of the United States Tax Court (Appendix A, infra, pp. A-1 to A-13, inclusive) in favor of the Commissioner of Internal Revenue is reported at 60 T.C. 950. The opinion of the Court of Appeals for the Eighth Circuit (Appendix B, infra, pp. A-14 to A-18, inclusive) affirming the Tax Court is reported at —F.2d—.

JURISDICTION

The opinion and judgment of the Court of Appeals were entered on November 25, 1974. Taxpayers' petition for rehearing was timely filed on December 9, 1974, and was denied on December 17, 1974 (Appendix C, infra, p. A-19). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Are the "passive investment income" termination provisions of Subchapter S, as contained in Section 1372(e)(5) of the 1954 Internal Revenue Code, as amended, applicable to the receipts of a business corporation derived from the conduct of that business, without regard to the fact that the receipts are derived neither "passively" nor from "investment" sources.

STATUTES AND REGULATIONS INVOLVED

Section 1372(e)(5) of the Internal Revenue Code of 1954, in its entirety, and the pertinent portions of U.S. Treasury Regulations on Income Tax (Section 1.1372-4(b)(5)(x)) are set forth in Appendix D, infra, pp. A-20 to A-21, inclusive.

of Richter and Company had terminated because the receipts of Richter and Company constituted "passive investment income" under Section 1372(e)(5) of the 1954 Internal Revenue Code as amended. It is agreed that if Richter and Company was a valid Subchapter S corporation during 1966 and 1967 the taxpayers were entitled to the net operating loss deductions claimed on their individual returns.

The Tax Court sustained the position of the Commissioner of Internal Revenue that the election of Henry J. Richter and Company had terminated. In its opinion (Appendix D, infra, pp. A-20), the Tax Court noted taxpayers' position that the termination provisions of Subchapter S were not intended to be applicable to corporations conducting active business operations (but were intended by Congress to deny the election to businesses with large amounts of investment type income such as royalties, rents, dividends, annuities and profits from the sale or exchange of stocks or securities) and noted that this position had been upheld by the Court of Appeals of the Fifth Circuit in *House v. Commissioner*, 453 F.2d 982 (CA 5 1972). However, the Tax Court concluded it would not follow *House v. Commissioner*.

The Court of Appeals for the Eighth Circuit affirmed the position of the Tax Court stating that in its view the applicable statute, Section 1372(e)(5), contained definitional language which, under that statute, caused the Subchapter S election of Richter & Co. to terminate.

REASONS FOR GRANTING THE WRIT

1. The issue presented in this case concerns the proper interpretation of the termination provisions contained in Section 1372(e)(5) of the 1954 Internal Revenue Code applicable to Subchapter S corporations. The decision of the Court of Appeals below holding that the termination provision of 1372(e)(5) are applicable to certain small business corporations adopting Subchapter S treatment, regardless of the fact that such businesses conduct active business operations and do not realize passive investment income in the ordinarily understood sense, has created a direct conflict with the decision of the Court of Appeals for the Fifth Circuit in *House v. Commissioner*, 453 F.2d 982, which decision held that the termination provisions of 1372(e)(5) are not applicable unless the income receipts of a corporation were "passive" in the commonly understood sense.[1] The availability of taxation as a Subchapter S corporation is a very important matter to numerous small business corporations, and in particular to those corporations conducting a small loan business or a securities dealership business, and resolution of this conflicting interpretation of Section 1372(e)(5) of the Internal Revenue Code and the appropriateness of standards of applicability, is therefore highly important to the orderly administration of the tax laws. Moreover, this conflicting interpretation among different Courts of Appeals falls within the purview of Rule 19-1(b) of the Rules of this Court, which indicates that such a conflict will be considered in granting a Writ of Certiorari.

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[1] Since the decision of the Appellate Court below, the United States Court of Appeal for the Tenth Circuit has rendered its decision in *Marshall v. Commissioner*, — F.2d —, 75-1 USTC Par. 9160, affi'g. 60 T.C. 242, in which the Tenth Circuit Court of Appeals sided with the Eighth Circuit Court of Appeals and held that the termination provisions of Section 1372(e)(5) were applicable in the case of a Subchapter S corporation actively engaged in the small loan business.

The Internal Revenue Code provisions relating to Subchapter S corporations were initially enacted by Congress in 1958. The legislative history attendant to this statute, as contained in Senate Report to the Technical Amendments Act of 1958, Section 68, 1958-3 Cum. Bul. 1008, clearly indicates that congress intended Subchapter S status to be available to corporations conducting active business operations and further intended to deny this status to businesses with large amounts of investment type income such as royalties, rents, dividends, interests, annuities and profits from the sale or exchange of stocks and securities. Therefore, Section 1372(e)(5) was adopted to prevent such corporations with substantial passive investment income to qualify as a Subchapter S corporation. Section 1372(e)(5), as originally enacted, provided for termination of Subchapter S status where sufficient receipts of a corporation constituted "personal holding company income."[2] The 1966 Amendment to Section 1372(e)(5) (Public Law 89-389) changed the heading of Paragraph (5) from "Personal Holding Company Income" to "Passive Investment Income" without specifying any reason for the change in terminology; however, the applicable Senate Committee Report did say: "New Subparagraphs (A) and (C) of Section 1372(e)(5) contain the *same general rule as existing law*." Senate Report No. 1007, 89th Congress, 2d Session (1966), 1966-1 Cum. Bul. 527, 541. (Emphasis supplied.)

The court below in the instant case, as well as the Court of Appeals for the Tenth Circuit in *Marshall v. Commissioner*,

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[2] Section 1372(e)(5) as originally enacted provided:

> 5. *Personal Holding Company Income*—An election under Subsection (a) made by a small business corporation shall terminate if, for any taxable year of the corporation for which the election is in effect, such corporation has gross receipts more than 20% of which is derived from royalties, rents, dividends, interests, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom). * * *

supra, have read Section 1372(e)(5) quite narrowly, indicating that since the Section purports to contain a definition of "passive investment income" any other interpretation is precluded. On the other hand, the position of the Court of Appeals for the Fifth Circuit, as set forth in *House v. Commissioner*, supra, which petitioners herein believe to be the correct interpretation of Section 1372(e)(5), is that Congress used the term "personal holding company income" and "passive investment income" in identifying the kind of income that would terminate the Subchapter S status of a corporation and that these terms were employed by Congress to make clear its legislative purpose and that such terms cannot be read in isolation. The Commissioner's position in *House*, that as a matter of statutory construction the words "passive investment income" apply to interest (or on a comparable basis to sales or exchanges of securities) was squarely rejected by the Fifth Circuit which held that the Commissioner would not be permitted to lift or isolate certain words from their context to give them a meaning that does violence to Congressional purpose.

2. The effect of the decision of the court below (as well as the decision of the Court of Appeals for the Tenth Circuit in *Marshall v. Commissioner*, supra), is to prevent certain businesses (such as securities dealers and small loan companies) which actively conduct a business operation from ever qualifying as Subchapter S corporations. In the case of a securities dealer involved in the case below, such a securities dealer is merely a merchant who purchases his stock in trade (i.e. securities) with the expectation of reselling at a profit (and not because of intervening rises in value), with the markup representing remuneration to the securities dealer for his labors as a middle man in bringing buyer and seller together. See *Stephens, Inc. v. United States*, 464 F.2d 53 (CA8, 1972), *George R. Kemon v. Commissioner*, 16 T.C. 1026 (1951). Thus the "doubt" expressed by the Court below in footnote 10 of its

opinion is ill-founded for the reason that market fluctuations are not the basis by which a securities dealer is compensated; but it is rather as a middleman-merchant who performs a marketing service. The opinion of the Court of Appeals below indicates some reservation that taxpayer's position "leaves room for considerable ambiguity, particularly as to standards for determining whether a securities (or other) dealer is sufficiently 'active' in the pursuit of its business to warrant Subchapter S treatment". However, there is absolutely no cause for such concern since the only requirement would be a factual determination that a particular taxpayer (such as a securities dealer or lending company) was actively engaged in that business. This factual determination is a frequent requirement for the applicability of various sections of the Internal Revenue Code, for example the deduction of trade or business expenses under Section 161, the special rules for determining capital gains treatment under Section 1231(b), the applicability of special inventory rules applicable to securities dealers under U.S. Treasury Regulations 1.471-5 etc. Therefore the problem of determining the active status of a corporate business is a common problem in the administration of the Internal Revenue Code provisions, and it is not unique with the Subchapter S termination provisions of Section 1372(e)(5).

The findings in the instant case are undisputed that during the years in issue, Henry A. Richter & Company bought for and sold from inventory only and held no stocks for investment (although it did hold such investment stocks in later years which were clearly identified as such). The fact that the inventory of Henry J. Richter & Company was subject to market fluctuation is of no consequence since this attribute is also present with respect to inventories of other corporate merchants all of whom qualify for Subchapter S treatment, such as livestock dealers, precious metal dealers, grain dealers and food brokers. By preventing a securities dealer (and small loan

company) from enjoying Subchapter S corporate status, the Court below and the Court of Appeals for the Tenth Circuit have interpreted Section 1372(e)(5) in such a manner as to cause discriminatory treatment among business, where there is absolutely no indication of Congressional intent to exclude certain businesses from benefits of Subchapter S. See *House v. Commissioner*, supra.

3. The basis of the holding of the Court of Appeals below (as well as that of the Tenth Circuit) appears to have been that the definitional provisions of Section 1372(e)(5)(C) relating to "sales or exchanges of stock or securities" and "interest" are complete; however, the result of these decisions is to lift or isolate the terms "sales or exchanges of stock or securities" and "interest" from their context, and to give these terms a meaning that does violence to congressional purpose. Moreover, such interpretations completely ignore the words "passive investment income" which were deliberately utilized by Congress to make clear its purpose and intention concerning this particular statute. *House v. Commissioner*, supra.

An additional effect of the ruling of the court below (as well as the ruling of the Court of Appeals for the Tenth Circuit in *Marshall v. Commissioner*) is that the result achieved thereby necessarily presumes a substantive change in the termination provisions of Section 1372(e)(5) as a result of the 1966 amendment to the statute (P.L. 89-389), since neither a securities dealer nor small loan company would come within the purview of a personal holding company. See *House v. Commissioner*, supra. However, such a presumed statutory change is inconsistent with the Senate Report to the statute indicated above and indicated in footnote 6 of the Tax Court opinion below (Appendix A-9), which clearly indicates that the statutory version contains the same general rule as existing law. Therefore, it is clear that no changes in the substance of the

termination provisions were intended by the 1966 amendment (which added subparagraph (C) to Section 1372(e)(5)), and any indication that such a change resulted can not be a correct interpretation of the statute in question.

4. The Commissioner of Internal Revenue has been inconsistent in his interpretation of the termination provisions of Section 1372(e)(5). While the court below, in the case of "the sale or exchange of stocks and securities" (as well as the Court of Appeals for the Tenth Circuit in the case of "interest") has apparently accepted the Commissioner's argument that it is not permitted to "look behind the normal characterization of a corporation's receipts in order to classify them as active or passive", the fact remains that in the case of "rents" (also part of the same applicable statute), the Commissioner has issued regulations and rulings which do in fact look behind the "normal characterization" of the receipts to determine whether business activities and services are present so as to avoid termination of a corporation's Subchapter S status. Seago, *Passive Income Limitations Under Subchapter S*, 52 Taxes, The Tax Magazine 112 (1974). Thus, taking into account the facts of each case, the Commissioner of Internal Revenue has ruled that rental payments received by a hotel corporation, warehouse company or property rental corporation are not "rents" for the purposes of the Subchapter S termination provisions of Section 1372(e)(5) of the 1954 Internal Revenue Code. U. S. Treasury Regulations Section 1.1372-4(p)(vi); Rev. Rul. 65-40, 1965 Cum. Bul. 429; Rev. Rul. 65-83, 1965-1 Cum. Bul. 450; Rev. Rul. 72-206, 1972-1 Cum. Bul. 177. There is no reason why the Commissioner should adhere to a strict characterization in the case of securities dealers and finance companies, but nevertheless look to the facts of each situation in the case of rents. While the opinion of the court below notes that the development of standards in this area is with the Commissioner, certainly the Commissioner has the duty of treating all taxpayers

similarly situated in a uniform and like-handed manner. In fact, the opinion of the court below notes (Appendix A-7) that the position of the Tax Court (which sustained the Commissioner of Internal Revenue) has been subject to criticism.

As indicated above, the effect of the ruling of the court below has been to create a conflict, and an indication of the confusion which has resulted in the administration and interpretation of Section 1372(e)(5) is shown by two recent decisions of the Tax Court in related cases concerning the Subchapter S status of a small loan company. In these cases involving two shareholders of the *same* corporation, the Tax Court reached opposite results, holding that the Subchapter S status did not terminate in the case of the taxpayer residing within the Fifth Circuit, and further holding that the Subchapter S status of the same corporation for the same year did terminate in the case of a taxpayer residing within the Eighth Circuit. *Puckett v. Commissioner*, 1974 T.C. Memo No. 235; *Doehring v. Commissioner*, 1974 T.C. Memo No. 234.

Petitioners earnestly submit that the issue presented in this case as a most significant one affecting many taxpayers who operate small businesses in corporate form, and as matters presently stand, the termination provisions of Section 1372(e)(5) have been interpreted in different ways by different Courts of Appeals resulting in conflicting interpretations and in non-uniform results among taxpayers similarly situated. The granting of Certiorari in this case will permit the Supreme Court to remove the conflict that has developed and to render a uniform and proper interpretation of Section 1372(e)(5) in its applicability to small business corporations.

CONCLUSION

This petition for a Writ of Certiorari should be granted.

Respectfully submitted

HARVEY G. SCHNEIDER
RASKAS. RUTHMEYER, SCHNEIDER,
& POMERANTZ
930 Paul Brown Building
818 Olive Street
St. Louis, Missouri 63101
Attorneys for Petitioners

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